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# Prepaid college plans: shrinking options, rising risks

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By Jessica Toonkel and [Jilian Mincer](#)

(Reuters) - Jim and Celeste Durkin thought when they began investing six years ago in Illinois state's prepaid college savings plan that they were locking in a bargain price if their daughter Caroline, who is now 10, eventually attended the University of Illinois.

That might not be the case. The plan took some risky bets on private equity and hedge funds and is now 30 percent underfunded and temporarily closed to new investments.

"It was highly recommended by investment professionals and people we knew, and with all of the uncertainty in the markets we thought it was a safe investment," Durkin said.

An Illinois state representative, Durkin is determined to do something about it: He expects to introduce legislation this month to make the plans more transparent.

The Illinois plan is in worse shape than most prepaid plans, but it isn't unusual in facing problems. Prepaid plans, popular college savings vehicles offered at one time in about 20 U.S. states, are increasingly running on empty.

About half of them have stopped taking new money, according to [Savingforcollege.com](http://Savingforcollege.com), and many of the rest are struggling. It means that the majority of Americans, including those in places such as Illinois and Tennessee, don't have access to a state plan, and the minority who do need to be very wary.

Declining market returns and rising tuition costs have been creating an unsustainable funding gap for the plans ever since the dotcom bust in 2000-2001. The financial crisis and its aftermath only made it worse.

Since the end of 2000, the S&P 500 stock index dropped 3 percent while tuition and fees at a public four-year school when adjusted for inflation climbed on average 72 percent in the last decade, according to the College Board, and financially strapped states have in many cases reduced or frozen funding for education.

It all means that at a time when families are particularly rattled by the volatility and low returns of financial markets and want the security of a prepaid plan, the college savings vehicles have become more expensive and higher risk than consumers realize.

Many states have significantly raised the amount consumers need to contribute to keep up with potential tuition hikes, and most don't guarantee the money will be available in the plans they oversee when the time comes to send junior to college.

Worst-case scenario - parents think they have paid for future college costs and then are suddenly told the money isn't all there, or even that the plan has collapsed because of investment losses (though that hasn't happened yet), and they have to make up the difference.

"People need to read the fine print and understand what kind of guarantee their plan really offers," said Andrea Feirstein, a consultant to college savings plans.

## A HISTORY OF DIFFICULTIES

Almost all U.S. prepaid plans are a type of so-called 529 college savings plan, which allow American parents to save for college costs without paying federal tax on investment returns if the assets are used for higher education expenses. Prepaid plans are professionally managed and allow families to lock in future tuition payments for universities in a particular state.

For example, a family could set a tuition rate for colleges within the state's boundaries at \$40,000 for four years when a child is five years old and spend the next 12 years contributing that. If the four-year course costs \$60,000 when the child gets to college, the family still only pays \$40,000, and will save \$20,000.

But while there may have been great bargains like that in the past, they are becoming rare.



Ohio, for example, closed its prepaid plan to new investments at the end of 2003 because actuaries anticipated potential shortfalls as investment returns slipped and tuition at public universities soared after the state lifted a lid on fees.

The decision was extremely difficult, said Jackie Williams, former executive director of the Ohio Tuition Trust Authority and former chair of the College Savings Plans Network. At the time, "We had money rolling in, everyone was looking for a guarantee in a time of uncertainty," she said.

While some states like Texas are putting the onus on state colleges to fund shortfalls, others are making consumers pay significantly more.

"The question for most prepaid plans is that if tuition keeps rising, who is going to pay?" said Betty Lochner, director of Washington state's prepaid plan, the \$1.9 billion Guaranteed Education Tuition Program. "Is it going to be the taxpayers, the universities or the consumers?"

In Washington, the answer right now is consumers. When the state legislature agreed to temporarily lift a 7.5 percent tuition cap, tuition immediately soared 19 percent. So the plan had no choice but to increase pricing for a year of tuition to \$16,300 from \$11,700 if a parent wants to enroll their child now.

Lochner hopes that tuition costs will level off and additional big hikes won't be necessary but the equation is a delicate one. "The question is at what point is your pricing too high and when will people stop paying," she said.

Another issue is that often families are under the impression that they are locking in current tuition prices, which is rarely the case, experts said.

"A surprising number of these plans don't tell you how their pricing compares to current tuition prices," said Joe Hurley, founder of Savingforcollege.com. "Everyone assumes they are getting it at current tuition prices and that's just wrong."

Hurley said most states are charging amounts above current prices. For example, in Washington state, today a parent would be locking in tuition at \$16,300, while the current University of Washington rate is \$10,346 a year.

To make such payments worthwhile, tuition costs will have to continue to skyrocket. Also a child would need to be ineligible for significant grant and scholarship funds, which could reduce the cost of a year's college for the parents.

#### DON'T ASSUME IT'S GUARANTEED

Fees aren't the only problem. Even prepaid plans that use "guaranteed" in their names, such as Pennsylvania's "529 Guaranteed Savings Plan," are not always backed by the state, meaning if the investments go sour, investors could potentially lose everything.

So far, that hasn't happened since most plans invest conservatively, but it is a possibility, particularly for families like the Durkins whose child won't be in college for some years. Investors are largely unaware of this risk. "In a prepaid program the only meaningful guarantee is if it is guaranteed by the state," said Len Wiser-Varon, a partner at Mintz, Levin, Cohn, Ferris, Glovsky and Popeo LLP, who advises the Massachusetts Educational Financing Authority.

Massachusetts, Florida, Mississippi and Washington are the only four states that guarantee their plans through full faith and credit of the state, meaning that if the plan goes bust, the state has to pay the promised tuition amount. The Texas plan is guaranteed by the state universities and colleges.

The plans run by Pennsylvania, Nevada and Michigan are "backed" only by the assets in the trust. If those assets are depleted due to risky investing or an "unpredicted" market event, investors may be out of luck, Levin said.

Then there are those plans, like the ones run by Maryland, Virginia and Illinois, which require legislative action for the state to pay back investors in the event of a funding shortfall. But experts said that doesn't necessarily mean funds are guaranteed because in states like Illinois and Maryland, lawmakers are only required to consider passing a law backing an underfunded plan, but not required to pass such a law.

For example, the Illinois plan - which should be able to make tuition payments for the next decade, according to a recent actuarial report - is backed by a "moral obligation." That means if the plan cannot meet its obligations, the governor would need to request funds from the General Assembly. But lawmakers do not have to support the request, said John Samuels, a spokesman for the Illinois Student Assistance Commission, which oversees the plan.

And given the current financial straits of many states, with cuts likely to balance the budgets in the next two years, getting that support won't be easy.

Virginia's plan comes closer to providing a full guarantee in that state law provides a financial guarantee in each year's budget to cover its plan in the event of a shortfall, which can only be changed by the General Assembly. And even that is subject to a veto by the Governor.

Illinois is not the only prepaid savings plan to run into trouble. In Alabama, families brought a class action suit over their plan, which was underfunded after tuition rose faster than expected and market returns plummeted. In July, a judge approved a settlement under which the plan would pay only the 2010 tuition rate, leaving families to make up any shortfall. The state supreme court has yet to rule on an appeal.

Few parents realize that the management of some plans are allowed to invest a big portion of the assets in higher-risk assets, such as hedge funds and private equity vehicles.

According to the Illinois plan's investment policy statement, its target allocation to alternative investments is 47 percent. The current allocation is 48.7 percent, said Samuels. "Anything above 20 percent in alternatives seems high given that these investments are not as liquid as others," said Feirstein, the 529 consultant.

The plan's external investment advisory panel has recently been reorganized and held its first meeting on December 29. "The Commission has made it clear that increasing transparency and developing a new investment policy are top priorities," Samuels wrote in an e-mail.

Kim Godden, a 38 year-old lawyer, started investing in the College Illinois! Plan when her daughter, Hannah, was born in 2007. Having put herself through both college and law school, it was very important to Godden to be able to pay for her daughter's education. "I am paying back my loans now and I didn't want that for my daughter," she said.

The College Illinois! Plan seemed like the perfect way for her to put money aside. "The plan was marketed as a sure thing," Godden said. "Now I am worried that the plan will go broke two years before my child goes to college."

(Reporting by Jessica Toonkel, editing by Jennifer Merritt, Jilian Mincer, [Martin Howell](#))

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